No. 10289.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

LOMBARD TRUSTEES, LTD., a Trust, and CHARLES S. LOMBARD, BERTHA M. LOMBARD and NORMAN M. LOMBARD, Trustees thereof,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REHEARING.

GEO. W. HELLYER,
JOHN B. SURR,
204 Citizens National Bank Building, San Bernardino,
Attorneys for Petitioner.

Parker & Baird Company, Law Printers, Los Angeles

TOPICAL INDEX.

PAGE

Certificate of counsel 13

TABLE OF AUTHORITIES CITED.

CASES.

PAGE

A. A. Lewis & Company v. Commissioner, 301 U. S. 384, 81 L. Ed. 1174 ..... 3, 4

Commissioner v. Vandergrift, 82 F. (2d) 387 6

Porter v. Commissioner, 130 F. (2d) 276 7

STATUTES.

Internal Revenue Code, Sec. 166 ..... 9, 12

Internal Revenue Code, Sec. 167 9

Treasury Regulation 94, Art. 1101-3 7

No. 10289.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

LOMBARD TRUSTEES, LTD., a Trust, and CHARLES S. LOMBARD, BERTHA M. LOMBARD and NORMAN M. LOMBARD, Trustees thereof,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REHEARING.

To the Court Above Named:

Petitioner respectfully requests a rehearing herein and a reconsideration of the single question discussed in the opinion filed May 21, 1943.

The trust involved was created November 3, 1935. Dr. Lombard contributed the property and was sole beneficiary until March 14, 1937, upon which date other members of his family acquired a part of the beneficial interest. In the opinion it was held the trust was an association during all of 1937. It would follow the trust was an association during all of 1936 and the part of 1935 elapsing after its creation.

No other court ever held a trust to be an association when there was a single beneficiary. The decision is of first impression and if it stands will have a far-reaching effect and probably be the most important decision handed down from this court in a decade.

There are innumerable trusts created by property owners for their sole benefit, wherein title to property is vested in a trustee or trustees to manage and handle generally. They are common. Since the decision was rendered, one came to our attention because of the death of a trustee. The owner of an orange grove and other property conveyed it to his brother and attorney, as trustees, to farm, handle, and manage generally, with broad powers of sale and investment, and to distribute the income to or upon the order of the grantor. This court says in the opinion that growing oranges is "certainly an agricultural and business enterprise." Therefore, that owner was engaged in business and he created and employed an organization in corporate form to take and hold this property and conduct a business for his benefit.

If the decision stands, the Treasury will certainly claim that the innumerable trusts of the nature of the trust last referred to are business trusts, taxable as associations. If this decision be correct, such other trusts are also associations. Any first impression decision upon an important point will, if correct, be extended and extended. Even if incorrect, it will be extended and do a world of damage until some court has the learning and courage to correct it.

We are not alone in our fears. C. C. Hogan, Esq., head of the trust department of Security-First National Bank of Los Angeles, writes:

> "After reading the brief and the decision of the Circuit Court of Appeals and discussing the matter in the office, we are impressed and frankly I am disturbed at the prospect of extending the application of what 'association' means under the income tax law to various similar trusts now being handled by trust companies where there is only a single beneficiary."

The decision declares that the only essential elements for an association are corporate form (which is found in every trust), a business purpose and engaging in business. It squarely holds the number of beneficiaries, whether one or plural, is unessential. In *A. A. Lewis & Company v. Commissioner,* 301 U. S. 384, 81 L. Ed. 1174 (decided May 17, 1937, more than two years after Morrissey), the United States Supreme Court declared the contrary. The facts of that case appear in the single syllabus which reads in full as follows:

> "A trust created by an owner of land with a view to its subdivision and sale, for the benefit of the grantor and of a real estate operator in whose hands the marketing of the property was placed and whose beneficial interest was limited to his commission upon the price for which lots should be sold, whereby the title was placed in a trustee whose duties were the merely ministerial duties of executing deeds at the direction of such real estate operator and the collec-

> tion and distribution of payments after the initial payment, and who had no power to control, direct, or participate in the conduct of the selling enterprise, is not an association to be taxed as a corporation, within the meaning of Sec. 701 (a) (2) of the Revenue Act of May 29, 1928, 26 U. S. C., Sec. 2701."

There the question here under discussion was squarely presented and argued. The Commissioner claimed, as here, that one beneficiary was sufficient. The argument of counsel for the Commissioner on this point is summarized at page 1175 of 81 L. Ed. in the synopsis of the argument, as follows:

> "The trust cannot escape taxation as an association on the ground that there are but one trustee and one beneficiary."

There were two persons interested in that trust, one the owner and the other the real estate operator. The Supreme Court held the real estate operator was in effect the agent of the owner, and the relation was that of principal and agent. Hence, there was a single beneficiary. The Supreme Court concluded its decision as follows:

> "We are not able to find in the situation an 'association' within the meaning of the statute under consideration, *because there are no associates* and no feature 'making (the trust) analogous to a corporate organization'." (Our emphasis.)

It will be noted the Court rejected the contention that the trust was an association on two grounds, one that the trust was not analogous to a corporation; the other that it lacked associates. The first point turned upon the fact stated in the decision, "The duties of the trustee were purely ministerial, with no power to control, direct, or

participate in, the conduct of the selling enterprise contemplated by the contract." The first point would, today, be resolved upon the ground that the trust did not have a business purpose of a nature sufficient to cause it to be an association.

In the *Morrissey* case, the Supreme Court had said:

> "'Association' implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business."

Now two years later, the Supreme Court squarely declares in the *Lewis* case that the term "association" as used in the statute will not be satisfied by a single beneficiary, or by a single beneficiary and his agent. As far as we are aware that was the last time the Treasury claimed, argued, held, or attempted to hold, that a trust of which the grantor was the sole beneficiary constituted an association until the instant case, when the contention was advanced for trading purposes by the technical staff in an endeavor to induce counsel for petitioner to accept February 10, 1937, as the date on which the association came into being—a date that no one on either side ever claimed was correct. Counsel in the technical staff fired a chance shot into the dark and appear to have brought down not only a bear but her entire family.

Not only is the decision, in all probability, the most important decision this court has rendered, but it is probably the briefest. Important facts are not stated. There is no discussion of the historical meaning of the term "association." There is no comment upon the numerous pronouncements of the Supreme Court and other courts defining the term and stating the elements

of an association. The opinion concerns itself only with incidental arguments, and the main argument and chief points are not referred to or answered.

The opinion discusses inconsequential facts such as "expectancy fractions." The next case and the case after that in which it will be sought to apply the rule of the decision will not have "expectancy fractions" and the reasoning on which the case has apparently turned will not be applicable. A first-impression decision should be reasoned and based upon broad principles that will be applicable in every case. If it cannot be so reasoned and based, it ought not to be rendered, for it is probably incorrect.

The decision stresses and appears bottomed on the ground that the trust here was in corporate form. "Corporate form" in the case of a trust is a red herring across the path of reason and is well calculated to lead astray, for both the strict trust and the business trust have resemblance to a corporation. During the development of the law on associations, there was much discussion of and concern about corporate form.

On March 2, 1936, less than three months after the decisions in the *Morrissey* and companion cases, this Court said in *Commissioner v. Vandegrift,* 82 F. (2d) 387:

> "There can hardly be a serious question as to the fact that the trust was carried on under a corporate form, but the Supreme Court indicates very clearly in Morrissey v. Commissioner, *supra*, that little consideration should be given to the form of organization under which the trust is operated."

By the time this Court reached *Porter v. Commissioner,* 130 F. (2d) 276, non-essential considerations had been thrown out of the window. This Court then said:

> "There are two tests to be applied to a trust in order to determine whether or not it is taxable as a corporation: (1) What is its purpose?; and (2) what is the extent of its business activity? Of the two, the first is the more important."

In the *Porter* case, nothing is said respecting corporate form. In the decision in the instant case, there is much said about corporate form. In the decision, the "corporate form" idea appears like the theme in a theme song. Three times the word "association" is followed by "corporate in form." And it is further written: "Petitioner, agreeing in our decision in the Porter case that the association is in corporate form, etc." In view of the fact the *Porter* case did not hold or intimate the trust there was in corporate form, or even discuss it, it may be doubted that petitioner agreed the trust was in corporate form. However, petitioner does agree the instrument and the organization in the *Porter* case and in the instant case were in "trust form," and if the expression "trust in form" were substituted for "corporate in form" where used in the opinion, there would be less likelihood of error.

The Treasury recognizes what has been said on the significance of "corporate form." In Regulation 94, Art. 1001-3 it is stated the result does not "depend upon technical arrangements or devices such as appointment or election of a president * * * the use of a 'seal,' the issuance of certificates to the beneficiaries * * * they are not essential * * * for the fundamental benefits * * *

are attained, in the case of a trust, by the use of the trust form *itself.*" (Emphasis that of regulations.)

In our brief, we quoted the Supreme Court and other courts showing that in their conception more than one beneficiary was essential to constitute an association. Then we said "The foregoing statements are distinctly recognized by the regulations" and quoted the regulations. We did not quote or rely upon the regulations to prove the trust was an association, which would be an affirmative. We referred to them rather to establish a negative, namely, that a trust with one beneficiary did not meet the Treasury's own concept and definition of an association. We pointed to the fact the Treasury was careful to indicate the number of trustees was unimportant, whether one or more, but always referred to plural beneficiaries and we quoted from the regulations: "The nature and purpose of a *cooperative* undertaking will differentiate it from an ordinary trust * * * the beneficiaries are to be treated as voluntarily *joining or cooperating with each other* in the trust, just as do members of an association." The decision states "we regard the plural word 'beneficiaries' as inclusive of the singular." It is difficult to understand how it may properly be said a sole beneficiary is engaged in a "*cooperative* undertaking" or in what way a sole beneficiary can "be treated as voluntarily joining or cooperating with each other."

Generally, the regulations are as exact as language permits. They incline to be all inclusive rather than exclusive when inclusiveness is desired by the Treasury. They appear framed on the theory it is better to tax a dozen taxpayers who should not be taxed than to permit one who should be to escape. If the Treasury deemed that a trust with a sole beneficiary was an association, it

is amazing to note how very careless it was in this regulation. After employing the plural form of "trustees," the Treasury, out of its usual abundance of caution, inserted in parenthesis "(or a trustee)."

Now this Court states the Treasury intended the word "beneficiaries," as employed by it in the regulation, to include the singular, or in other words, the Treasury intended to state that a trust for business purposes with a single beneficiary was an association. We can't and don't believe it!

The opinion argues, "If petitioner's contention were correct, it could as well be argued that there could be no trust taxation where there is but a single *cestui*." The answer is, it could not be and would not be so argued. This regulation was for the purpose of aiding in determining when a trust is to be classified as an association and not when an association is to be classified as a trust. The term "trust" has a well established meaning. It was not necessary for the Treasury to issue any regulation as an aid to determining the number of beneficiaries required in the case of a trust and it has not purported to do so. Sections 166 and 167 of the Internal Revenue Code and the regulations thereunder mostly apply to trusts with a single beneficiary. The regulation in which we are interested was for the purpose of aiding in determining what characteristics in a trust would cause it to be classified as an association. From the constant use of the plural form accompanied by references to *cooperation* by beneficiaries, it certainly is proper to state the regulation recognizes that before a trust may be held an association there must be a plurality of beneficially interested persons. In any event, the regulation does not establish the affirmative, namely, that a trust with one

beneficiary is an association. The decision leaves the impression that the Court relies upon the regulation to establish that plural beneficiaries are not necessary for a trust to be an association.

In the next to the last paragraph of the opinion is the statement that holding all of the beneficial interest under the nomenclature of "expectancy fractions" is analogous to ownership of all the shares of a corporation. Whether the beneficial interest was given the fanciful name of "expectancy fractions" or the usual name of "beneficial interest" which, when held by more than one, is commonly expressed in fractions or percentages, has not the slightest significance. It may be said the holding of the entire beneficial interest in an association is, in a sense, analogous to ownership of all the shares of a corporation, but so is the ownership of the entire beneficial interest in a strict trust (if such be possible after this decision) equally analogous to the ownership of all the shares in a corporation.

The significance of the last two sentences in the paragraph of the opinion under comment is not clear. It is said "The fact that a stockholder owning all the shares of a corporation is also a member of its board of directors, as here the beneficiary was one of the trustees, does not make it any the less a corporation." The statement is true, but what is the relevancy? No one has claimed or would claim the fact that a sole shareholder was a director of the corporation dissolved the corporation, or caused the corporate veil to be pierced, although there are numerous cases where the corporation has been treated as a dummy. Nor are we aware that any one has claimed or would claim the fact that a sole beneficiary was one of the trustees, dissolved the trust, or pierced

the trust veil. Possibly the paragraph of the decision under comment is intended to convey the thought that as all of the stock of a corporation is sometimes held by one person, it should make no difference that all of the beneficial interest under a business trust was held by one person.

The argument should be addressed to Congress and not to the Courts. The sole question here is, what did Congress mean when it declared the term "corporation" included associations, joint-stock companies and insurance companies? Did it intend thereby to group with and tax as a corporation a trust of which the grantor was the sole beneficiary? Does such answer the concept of association? This case cannot be decided correctly without considering and determining the meaning of the term "association" as used in the statute. How can the definitions in the dictionaries and in the numerous cases be ignored? Either the various pronouncements of the Supreme Court and other courts were meaningless drivel, or the decision is erroneous.

In passing, it may be remarked any assumption that all of the stock of a corporation may be held by one shareholder is unwarranted. A corporation is always of statutory origin. Whether or not all shares of a given corporation may be held by one person depends upon the law of the state in which incorporated. Such would not have been possible in the case of a California corporation prior to 1929, and such is not now possible in the case of many corporations.

In the last paragraph of the opinion it is written:

> "Petitioner contends that it cannot be taxed as a corporation because the single beneficiary must in-

clude in his gross income an amount equal to petitioner's income. This contention begs the question. Since petitioner is an association, corporate in form, it must be taxed under Sec. 1001 (a) (2) as a corporation. It makes no difference whether the sole beneficiary be taxed as a *cestui que* trust or a stockholder—an issue not here presented."

In our brief, as an incidental aid shedding some light indirectly upon the question under discussion, we stated the tax on the trust income before others became associated with Dr. Lombard, would fall on Dr. Lombard. That was also the initial contention of the Commissioner, only he used February 10, 1937, as the date others became associated, whereas, we deemed the correct date was March 14, 1937.

We wrote at page 19 of our reply brief, "Any trust is taxable as a corporation during any time it is legally an 'association.' If the trust in the instant case was not an association prior to March 14, 1937, then the trust is not to be taxed as a corporation on income prior to March 14, 1937. Rather, such income is taxable to Dr. Lombard under Section 166 of the 1936 Revenue Act." It seems to us the Court merely reiterates what we have stated and there is nothing to decide on this point and no question has been begged.

But the last sentence in the paragraph of the opinion above quoted is either irrelevant and has no place in the opinion or it is erroneous. Of course, there is no issue whether Dr. Lombard is taxed "as a *cestui que* trust or a stockholder" nor could there be one. The only question is, to whom is the income prior to March 14, 1937, taxable? If taxable to Dr. Lombard it is not taxable to the

trustees, and if taxable to the trustees it is not taxable to Dr. Lombard. Double taxation in such an instance would be unconstitutional.

This case can be correctly decided only by full consideration of the meaning of the term "association." Because of its importance it should be reheard.

Petitioner requests a rehearing.

Respectfully submitted,

GEO. W. HELLYER,
JOHN B. SURR,
Attorneys for Petitioner.

Certificate of Counsel.

We hereby certify that in our judgment the foregoing petition for rehearing is well founded and we further certify that said petition is not interposed for delay.

GEO. W. HELLYER,
JOHN B. SURR,
Counsel for Petitioner.